MSP #20 IRS COLLECTION EFFECTIVENESS: The IRS's Failure to Accurately Input Designated Payment Codes for All Payments Compromises Its Ability to Evaluate Which Actions Are Most Effective in Generating Payments

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TAXPAYER RIGHTS IMPACTED[1]

- *The Right to Quality Service*
- *The Right to a Fair and Just Tax System*

DEFINITION OF PROBLEM

IRS guidance instructs revenue officers (ROs) to designate every payment they receive from a taxpayer with a specific code.[2] ROs are directed to input a two-digit Designated Payment Code (DPC) to help identify payments, indicate application of the payment to a specific liability, and identify the event that primarily precipitated the payment (*e.g.*, liens, levies, offers in compromise, and installment agreements).[3] Congress has mandated such accounting for all federal payments.[4]

As discussed previously in the National Taxpayer Advocate's 2009 Annual Report to Congress, the IRS is not consistently or accurately applying DPCs, which reduces the IRS's ability to assess the effectiveness of its collection actions.[5] In calendar year (CY) 2014, 87 percent of payments either had no DPC or defaulted to DPCs of "00" (undesignated payment) or "99" (miscellaneous).[6] A 2012 Treasury Inspector General for Tax Administration (TIGTA) report raised similar concerns. Specifically, the report showed that 77 percent of payments reviewed were processed without the required DPC, including payments received after a Notice of Federal Tax Lien (NFTL) was filed.[7] Additionally, 34 percent of payments that did have a DPC placed on the payment had an incorrect DPC.[8] A recent IRS study also found that

1 *See* Taxpayer Bill of Rights, *available at* www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

2 Internal Revenue Manual (IRM) 5.1.2.8.1, *Designated Payment Codes* (Sept. 26, 2014).

3 IRM 5.1.2.8.1, *Designated Payment Codes* (Sept. 26, 2014).

4 *See generally* 31 U.S.C.A. §§ 3512, 3513; 31 U.S.C.A. § 3302(e).

5 National Taxpayer Advocate 2009 Annual Report to Congress 17-40 (Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of Law, Fail to Promote Future Tax Compliance and Unnecessarily Harm Taxpayers*).

6 IRS, Compliance Data Warehouse (CDW), Individual Masterfile (IMF) Transaction History Table, Major Transaction Codes, Transaction File Cycle 201508, Transaction Dates from Jan. 1 to Dec. 31, 2014.

7 TIGTA, Ref. No. 2012-30-026, *Designated Payment Codes Are Inaccurate and Ineffective* (Mar. 28, 2012).

8 *Id.*

Adopting a consistent and accurate use of Designated Payment Codes (DPCs) would better ensure that attempts to collect an outstanding tax are useful, effective, and do not compromise a taxpayer's *right to a fair and just tax system* by taking actions that financially harm the taxpayer and have little chance of yielding the desired result.

certain DPCs were too vague to be helpful, that IRS DPC guidance is inconsistent, and that an absence of a systemic review of DPCs impedes the IRS's ability to obtain useful information.[9]

The input of DPCs provides a way to track taxpayer behavior and future compliance but is ineffective when the IRS does not consistently or accurately apply the codes to all subsequent payments. Such failure prevents the IRS from measuring what actions, including processes such as the notice stream and the filing of an NFTL, were most successful in getting the taxpayer to pay on a balance due account. As a consequence, the IRS is blindly applying its broad collection powers and resources rather than analyzing accurate information to determine funding priorities (*i.e.*, what actions — sending a letter, making a phone call, or taking collection action — would yield the best return on investment).

The study recommended several common sense improvements, which IRS Collection officials rejected as too costly. In other words, the IRS determined it was better to continue to operate under a collection strategy conceived in a vacuum rather than adopt an approach that increases collection effectiveness and minimizes harm to the taxpayer. Adopting a consistent and accurate use of DPCs would better ensure that attempts to collect an outstanding tax are useful, effective, and do not compromise a taxpayer's *right to a fair and just tax system* by taking actions that financially harm the taxpayer and have little chance of yielding the desired result.

ANALYSIS OF PROBLEM

Background

The IRS receives taxpayer payments for several reasons and through various methods. For example, some payments are voluntary, such as payments submitted with a timely filed tax return. Other payments are submitted in response to IRS activities, such as receipt of an IRS notice or the filing of a lien, when the taxpayer has a balance due account. The IRS established two-digit DPCs to identify the event (*e.g.*, lien, levy, seizure) that was primarily responsible for the subsequent payment.[10] The DPCs are applied at the time the subsequent payment is processed.[11]

Congress has mandated using payment codes and tracking on a national basis to determine the revenue effectiveness of specific collection activities.[12] Congress's mandate to use such codes was largely designed to ensure that agencies having custody of public money kept accurate records of amounts received,

9 IRS, *Designated Payment Code Review Report* (Dec. 17, 2012). This report was conducted in response to concerns expressed by the National Taxpayer Advocate and TIGTA. *See* National Taxpayer Advocate 2010 Annual Report to Congress 250-66; National Taxpayer Advocate 2009 Annual Report to Congress 17-40; National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18. *See also* TIGTA, Ref. No. 2012-30-026, *Designated Payment Codes Are Inaccurate and Ineffective* (Mar. 28, 2012).

10 These are generally balance due payments. Other payments, such as Estimated Tax Payments, Federal Tax Deposits, and payments with filed returns are designated by the nature of the payment, whether received in paper or electronic form.

11 See IRM 5.1.2.8.1, *Designated Payment Codes* (Sept. 26, 2014). *See also* IRM 3.11.10.5.10, *Designated Payment Code* (Jan. 1, 2015); IRM 21.3.4.7.1.3, *Designated Payment Code* (Oct. 1, 2014).

12 *See generally* 31 U.S.C.A. §§ 3512, 3513; 31 U.S.C.A. § 3302(e).

transferred, and paid, and to provide the President, Congress, and the public annual updates on the financial condition of the United States government.[13]

A DPC serves a three-fold purpose. The code:

- Facilitates identification of payments designated to trust fund or non-trust fund employment taxes;
- Indicates application to a specific liability when a civil penalty includes a Trust Fund Recovery Penalty and other penalties; and
- Identifies the event that resulted in payment.

The IRS requires ROs to assign the appropriate DPC to subsequent payments on the payment voucher documents Form 809, *Receipt for Payment of Taxes*, and Form 3244, *Payment Posting Voucher*. These forms are then forwarded to an IRS submission processing center, where the payment is applied to the taxpayer's balance due account. Although IRS procedures require employees to code the sources of payments received when certain transaction codes (TCs) apply, the use of DPCs is not mandatory in all other situations.[14]

The Lack of Specific and Consistent Guidance on How DPCs Are Applied Throughout the IRS Reduces the Reliability and Usefulness of the DPC Data

Accurate DPCs are important for drawing meaningful conclusions about the effectiveness of IRS activities and making data-driven policy decisions about service, enforcement, and resource allocation. Currently, the majority of DPCs are input manually, which make the DPCs subject to human error.[15] This manual selection process is open to interpretation and may result in unreliable data and may account, in part, for the high percentage of DPCs that are either undesignated payments or miscellaneous. For instance, in CY 2014, 87 percent of payments either had no DPC or defaulted to DPCs of "00" (undesignated payment) or "99" (miscellaneous).[16] A 2012 TIGTA report showed that 106 (77 percent) of the 138 subsequent payments reviewed were processed without the required DPC. In addition, 11 (34 percent) of the 32 subsequent payments that had a DPC were not accurate.[17] Employees may resort to DPC 00 or 99, or inputting no DPC at all, because they cannot identify a DPC specific enough to match the payment.

The DPC 06 is an example of a DPC that is not specific and may lead to inaccurate coding of a payment. The IRM 3.11.10.5.10 states that the DPC 06 is to be used to identify proceeds received from a "seizure or sale." The failure to provide a more specific definition of DPC 06 may result in the mislabeling of a payment. For instance, an employee may think that the DPC is only appropriate to use for property that is seized and sold, but not for seized cash. This may ultimately result in the employee inputting a DPC 00 or 99, or no DPC at all.

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13 *Id.*

14 IRM 5.1.2.8, *Designated Payment Codes* (June 20, 2013); IRM 3.11.10.5.10, *Designated Payment Code* (Jan. 1, 2015); IRM 21.3.4.7.1.3, *Designated Payment Code* (Oct. 1, 2014). The use of a DPC on all posting documents/vouchers is mandatory when the following TCs are involved: "640" Advance Payment of Determined Deficiency or Underreporter Proposal; "670" Subsequent Payment; "680" Designated Payment of Interest; "690" Designated Payment of Penalty; "694" Designated Payment of Fees and Collection costs; and "700" Credit Applied. For other TCs (*e.g.*, "610" Remittance with Return; "611" Dishonored Remittance with Return; "612" Correction of TC 610 Processed in Error; "641" Dishonored Advance Payment), DPCs are not required. TCs are numeric codes for all system actions on the IRS Integrated Data Retrieval System (IDRS). IRS, Document 6209, *IRS Processing Codes and Information* (2010), 8-1 - 8-42.

15 Manually-input DPCs are determined using the source document that accompanies the payment. The source document may be the tax return, taxpayer letter, taxpayer correspondence, or a posting voucher.

16 IRS, CDW, IMF Transaction History Table, Major Transaction Codes, Transaction File Cycle 201508, Transaction Dates from Jan. 1 to Dec. 31, 2014.

17 TIGTA, Ref. No. 2012-30-026, *Designated Payment Codes Are Inaccurate and Ineffective* (Mar. 28, 2012).

Additionally, IRS guidance on when to use a particular DPC is insufficient, resulting in inconsistent and inaccurate determinations. For example, the definition of DPC 99 is both inconsistent and vague in the Collection (Part 5), Submission Processing (Part 3), and Accounts Management (Part 21) IRM sections. Definitions vary from:

- Miscellaneous payment (do not use if another DPC Code is applicable);[18]
- Miscellaneous payment other than above;[19]
- Miscellaneous;[20] and
- Miscellaneous payment other than 01 through 14.[21]

The IRS should develop consistent guidance throughout the IRM as to when IRS employees should use DPC 99, rather than having different instructions for employees working in different divisions in the IRS. The lack of specificity and consistency in how DPCs are applied reduces the reliability and usefulness of the DPC data.

Transitioning From Mostly Manual to Systemic Input of DPCs Would Allow Regular Reviews and Improve Accuracy

Accurate Designated Payment Codes (DPCs) are important for drawing meaningful conclusions about the effectiveness of IRS activities and making data-driven policy decisions about service, enforcement, and resource allocation.

Regular review of DPCs is important for verifying the input. However, two-thirds of all DPCs, or about 69 percent, are input manually and only 23 percent of DPCs are input systemically and are subject to review.[22] Thus, the majority of DPCs are not routinely reviewed. As discussed above, the reliability of manually-entered DPCs is questionable. Because of this unreliability, DPC information is often not taken into consideration when evaluating the effectiveness of IRS activities that supposedly led to a payment. Increasing the systemic input of DPCs may reduce errors and improve the integrity of the DPC data, simultaneously enhancing the reliability of DPC information for determining the effectiveness of specific IRS enforcement or taxpayer service activities.

Several state revenue departments use a systemic input method. These states have noticed considerable improvement in the accuracy of payment codes. The State of New York has developed a series of analytic measures that capture systemic payment data that allows for determining the best collection stream for taxpayer accounts.[23] Additionally, New York uses the codes that are input systemically to distinguish between a wage levy and a bank levy, and uses this information for determining which is more effective. The analysis of systemically input payment data showed a significantly higher case resolution rate for wage levies compared to bank levies.[24] Transitioning from a manual input of a majority of DPCs to a mainly systemic DPC process would increase the accuracy of payment data and would allow meaningful analysis of IRS activities that led to a payment.

18 IRM 5.1.2.8.1.3.1.1(1), *Examples – Using DPCs* (Aug. 15, 2008).

19 IRM Exhibit 21.1.7-5, *Designated Payment Code (DPC)* (July 17, 2014); IRM 3.11.10.5.10(8), *Designated Payment Code* (Jan. 1, 2015); IRM 3.12.10.3.23(3), *Field 01DPC – Designated Payment Code (DPC)* (Jan. 1, 2015); Exhibit 3.17.278-1, DPC Codes (Oct. 1, 2014).

20 IRM 21.3.4.7.1.3(2), *Designated Payment Code (DPC)* (Oct. 1, 2014).

21 IRM 3.8.45.9.1(3), *Designated Payment Codes (DPCs)* (Nov. 13, 2014).

22 IRS, *Designated Payment Code Review Report* (Dec. 17, 2012). No DPC was used at all for eight percent of the payments reviewed in this report.

23 IRS, *Designated Payment Code Review Report* (Mar. 11, 2013). *See also* Memorandum from Alan Gilds, IRS Senior Program Analyst for Field Operations, Review, and Enforcement, to New York Department of Revenue (May 14, 2014).

24 IRS, *Designated Payment Code Review Report* (Dec. 17, 2012).

Even if the IRS is unable to immediately transition to a systemic process for the input of all DPCs, it should require regular reviews to verify that manually-input DPCs are correct. These regular reviews would also identify common errors that the IRS can address through additional guidance to employees.

The input of a Designated Payment Code provides a way to track taxpayer behavior and future compliance but is ineffective when the IRS does not consistently or accurately apply the codes to all subsequent payments. Such failure prevents the IRS from measuring what actions… were most successful in getting the taxpayer to pay on a balance due account. As a consequence, the IRS is blindly applying its broad collection powers and resources rather than analyzing accurate information to determine funding priorities.

Implementing IRS DPC Study Recommendations is a Good Starting Point to Improve DPC Input Accuracy and Reliability

The IRS has acknowledged some of the problems discussed above in a recent report that was conducted in response to concerns expressed by the National Taxpayer Advocate and TIGTA.[25] This study made a number of recommendations, which were presented to an IRS review implementation team and the Director of Collection Policy.[26] On March 11, 2013, the DPC review implementation team and the Director of Collection Policy finalized which recommendations would be implemented and which would not.[27] The most significant findings and recommendations include the following:

1. Consider using two DPCs to distinguish between wage levies and non-wage levies and use a systemic timing approach rather than manual input;
2. Multiple DPCs can apply to one type of payment. This requires a systemic or manual determination to use one DPC rather than another. DPCs should be reviewed to ensure that they are specific enough that they can only be applied to one payment situation; and
3. DPC analysis program owners should conduct periodic accuracy reviews of the DPC selection criteria.[28]

The IRS refused to adopt these recommendations primarily because of a lack of resources. The first recommendation listed above was rejected by the DPC implementation team and the Director of Collection Policy, because it determined that creating two separate DPCs, one for wage levies and one for non-wage

25 IRS, *Designated Payment Code Review Report* (Dec. 17, 2012). *See* National Taxpayer Advocate 2010 Annual Report to Congress 250-66 (Most Serious Problem: *The IRS Should Accurately Track Sources of Balance Due Payments to Determine the Revenue Effectiveness of Its Enforcement Activities and Service Initiatives*); National Taxpayer Advocate 2009 Annual Report to Congress 17-40 (Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of Law, Fail to Promote Future Tax Compliance and Unnecessarily Harm Taxpayers*); National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18 (TAS Research Study: *The IRS's Use of Notices of Federal Tax Lien*). *See also* TIGTA, Ref. No. 2012-30-026, *Designated Payment Codes Are Inaccurate and Ineffective* (Mar. 28, 2012).

26 IRS response to TAS information request (Sept. 1, 2015).

27 *Id*.

28 IRS, *Designated Payment Code Review Report* (Dec. 17, 2012).

levies, would only be feasible if a systemic approach could be used rather than inputting the codes manually.[29] The explanation of this determination went on to say that the manual input of these two different DPCs would have to be reviewed manually, which would be time-consuming, and the IRS currently does not have enough resources to devote to such a review. The only other alternative would be to adopt a systemic approach, which the review team and the Director of Collection Policy deemed too costly.[30] The remaining two recommendations were also rejected because they were too costly.[31] They would both depend on the IRS adopting a systemic approach to DPCs rather than its current manual input approach.

The decision to reject these recommendations on the basis of a lack of resources was never shared with the IRS Commissioner, Deputy Commissioner for Services and Enforcement, or the National Taxpayer Advocate. Failing to adopt these recommendations because of resources is shortsighted and inexcusable, perpetuating the IRS's conduct of collection actions in a vacuum. Improving the accuracy and reliability of the DPCs can lead to the most efficient use of IRS resources based on knowing what IRS activities most likely resulted in a payment from the taxpayer. Moreover, a collection strategy based on ignorance and guesswork increases the risk of taking collection actions that are more intrusive than necessary, thereby undermining taxpayer trust in the system and undermining taxpayers' *right to privacy*.

CONCLUSION

The IRS is not consistently or accurately applying DPCs, which reduces its ability to assess the effectiveness of collection actions and service initiatives. Without accurately coding all the payments it receives, the IRS cannot fully meet its legal requirements to measure its business results.[32] It also cannot meet its strategic objective of developing a data-driven approach to allocating resources and making effective service, enforcement, and resource allocation decisions.[33] Finally, internal and external stakeholders are unable to accurately assess the effectiveness of IRS enforcement activities and service initiatives.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Revise IRM guidance and guidelines for lockbox receipts to require the entry of specific DPCs on all balance due payments.
2. Require Submission Processing employees to verify the presence of an appropriate DPC on payments by conducting regular quality reviews.
3. Provide clear and specific guidance about the circumstances under which employees can use a miscellaneous DPC.
4. Implement systemic input of most payment codes.

29 IRS response to TAS information request (Sept. 1, 2015).

30 *Id.*

31 *Id.*

32 *See, e.g.*, Treas. Reg. § 801.6(d)(1).

33 IRS Strategic Plan 2014-2017, *available at* http://core.publish.no.irs.gov/pubs/pdf/p3744–2014-06-00.pdf. *See also* U.S. Department of Treasury, *Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance* (July 8, 2009), Component 2: *Make a Multiyear Commitment to Research*, *available at* http://www.irs.gov/pub/newsroom/tax_gap_report_-final_version.pdf.